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China Grain Reforms

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Report Highlights:

China's latest grain reforms are aimed at strengthening State control over the national grain system, rather than make it more market sensitive. The reforms appear to do little to solve the country's fundamental agricultural problems, such as chronic overproduction and a terribly inefficient distribution system. Nor are the likely to solve either the fiscal or management problems that plague China's grain bureau system, which last year lost an estimated USD1.8 billion a month. The reforms do nothing to enhance the WTO compatibility of China's agricultural sector.

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Introduction

For years, Chinese farm policies have pursued the often conflicting goals of trying to keep food prices low, while trying to keep farm incomes high. To keep agricultural and food prices at the desired levels, the government has had to intervene heavily in the market, incurring staggering losses. With last year's losses on grain distribution running at an estimated \$1.8 billion a month, China's new Premier, Zhu Rongji, put grain reforms at the top of the list of reforms he announced at the end of the National People's Congress in March. The reforms he proposed, however, were all aimed at cutting the Government's large financial losses and reducing mismanagement, rather than introducing reforms to make the grain system more efficient or market-oriented.

The reforms do little to solve some of the more fundamental problems of Chinese agriculture, such as chronic overproduction and a terribly inefficient distribution system. Nor are they likely to solve either the fiscal or management problems that plague China's grain bureau system. In fact, there is already evidence that the reforms will lead to new problems. Further, the reforms bring Chinese farm policies no closer to where they need to be for China to join the WTO.

The following report is based on extensive travel to most of China's major grain producing provinces since the grain reforms were announced. Meetings were held with scores of provincial and local grain bureau officials, as well as farmers and grain station operators. Meetings were also held with grain policy officials in several parts of the central government and the new grain reforms were also discussed with numerous Chinese scholars, government advisors and individuals from Chinese and foreign national grain companies.

Four Separations, One Perfection ...

The mantra of the new grain reform, "four separations and one perfection," was first articulated by Premier Zhu in the spring of 1998. The new policy aimed to:

- * separate policy functions from commercial functions
- * separate food security stocks from commercial stocks
- * separate central government duties from local government duties
- * separate old debt from new debt
- * perfect a system whereby market prices respond to supply and demand conditions

Policy vs. Commercial Functions

In the past grain stations frequently operated businesses such as flour mills, crushing plants, hotels and restaurants. If these enterprises lost money, they turned to the grain station to cover their losses, which in turn asked the central government for loans. Because the funds for enterprises owned by the grain station were often co-mingled with funds used to manage government grain stocks, it was difficult to see where losses were coming from. Under the new reforms, the central government will no longer be responsible for covering the losses incurred by the grain bureaus as a result of the activities of their other enterprises.

Security vs. Commercial Stocks

Under the reforms stocks owned by the central government for national emergencies will be separated from stocks held by prefectural and local governments for short term commercial purposes. In the past, because of

poor accounting systems, the central government did not have adequate control over the stocks it stored with local grain stations. There were reportedly occasions when the central government ordered local grain stations to release grain to stabilize rising prices, only to be told that the central government's grain had all been sold when prices were lower, and that everything left was owned by the local government. Under the reforms the central government's State Administration for Grain Reserves (SAGR) is supposed to manage the nation's strategic reserves directly, rather than commingling its stocks with those held by local governments.

Central vs. Local Government Responsibilities

In order for the first two separations to succeed, there will have to be a clearer delineation between what the central government is responsible for what the local government grain stations are responsible for. The central government will be responsible for setting national food security policies and managing the macro grain supply situation, including regulating imports and exports, controlling stocks assigned to the national reserve and regulating prices to ensure that farmers maintain the proper "enthusiasm" to grow grain. Local government grain bureaus will be responsible for procuring grains (above and beyond those for the national reserve) and selling these onward to users, such as feed and flour mills. In effect, the local grain stations will operate in the future as commercial enterprises.

Old vs. New Debt

By the end of 1997, China's grain bureau system, nationally, was reportedly losing RMB 14.5 billion (about \$1.8 billion) a month, through grain purchases, storage and loan servicing costs, as well as maintaining a bureaucracy that employed four million people. Most local grain bureaus have been running at a loss for several years and they have accumulated substantial debts. Many of these debts, the grain bureaus argue, are the result of previous government policies which forced them to buy grain from farmers at high prices, and then to hold it off the market. Therefore, they feel they should not be held accountable for this old debt. On the other hand, these local grain stations still possess the grain, which presumably has some value. Thus a compromise on all debt was reached: the central government will be responsible for the interest on old debt while the local grain stations will be responsible for the principal. For new loans, the local grain bureaus will be responsible for both principal and interest.

A More Perfect Market?

In order to ensure the success of these four separations, the new policy takes a step back from western style market reforms by calling for increased State control over China's grain markets. The State Administration for Grain Reserves (SAGR) issued new regulations in June specifying that:

- Only grain bureaus can buy grain from farmers.
- The grain bureaus must buy all the grain that farmers want to sell.
- Grain bureaus may not sell grain at a loss.

A two tier price system would remain in place whereby farmers would be paid a fixed price for grains they are obliged to sell to the grain bureau (called the "quota price"), and a lower but still fixed price, called the "protected price," for any remaining grain they wish to sell. The grain stations are required under the new policy to sell the grain at a price which covers costs and which includes a small profit. In theory only the grain bureaus will possess grains in sufficient quantity to sell to commercial users and therefore they should be able to control supplies to keep prices high enough to cover their costs.

The costs of China's grain bureaus are enormous. With a staff of 4 million, Personnel costs are burdensome, particularly since grain bureau staff generally enjoy a full package of benefits including housing, medical care and retirement benefits. Overhead costs are also high because the physical distribution system remains inefficient, with most grain bagged before it is sold rather than being handled in bulk.

In recent years, many small private grain traders have begun purchasing grain from farmers and reselling it to millers. These firms generally have much lower overhead than the grain bureaus, and they have often been able to undercut the grain bureau's prices. There have been reports of traders who bought grain from farmers at prices below what farmers could have received if they had delivered their grain to their local grain bureau. However, in most cases these private traders have provided much needed services in procuring, storing and marketing grain.

To help the grain bureaus back onto their feet financially, the reform program gave grain bureaus back their monopoly position in handling grain by prohibiting private grain traders from buying grain directly from farmers. Farmers will continue to be permitted to sell small amounts of their own grain on the local market, but only the grain bureaus will be permitted to buy grain from farmers in quantity.

To help cut overhead costs, the grain bureaus have been ordered to cut their staff from 4 million to 1 million by the year 2000. Some grain bureaus have plans in place spelling out how many people will be cut each year, but to date very few cuts have been made. The grain bureaus have also been directed to separate the management of their non-grain businesses, such as hotels, from their overall operations. It is likely that they will meet their goals for staff reductions by transferring staff to these non-grain-related businesses.

There are probably few other countries where the aphorism "perception is reality" is more true than in China, given its physical and demographic size combined with serious limitations on the dissemination of accurate and timely information on just about any topic. Thus, if the reforms increase the perception of increased government control over grain markets, the perception that the grain bureau system is being disciplined and will be more responsive to farmers' interests in the future, many Chinese believe this in itself might improve market efficiency and stability.

... and Two Paradigm Shifts

The implementation of this year's reforms also include two changes which have not been discussed in public announcements. First, in order to cover their costs, grain bureaus are required to raise their resale prices to industrial users and consumers, rather than cutting the procurement prices they pay to farmers. This pricing policy will, in effect, transfer resources from urban consumers to rural areas. This is consistent with a growing realization that rural development is vital to China's continuing economic growth as policy makers look for new markets to replace markets lost to the Asian financial crisis. China's leaders are also responding to the widening gap between rural and urban incomes. Better farm incomes are thus coming to be seen as an objective in themselves, rather than a means to increase grain production.

For most of China's history, urban food prices have been kept artificially low through various government schemes. Communes in the 1950's and 1960's, for example, were designed partly to support industrial development by assuring stable supplies of reasonably priced food. As the communes started breaking up in the early 1980's, agricultural policies continued to focus primarily on increasing grain production. Higher farm

income was a side benefit of increased grain production rather than an end in itself. Thus, public discussions of the new policy centers on the need to set prices high enough to “stimulate the enthusiasm of farmers” to plant more grain.

However, local grain bureau officials acknowledge that their new pricing structure should result in a real transfer of income from urban consumers to farmers. Already, commercial users (i.e., feed and flour mills) and residents in Beijing and other urban centers are reporting higher grain prices. This point has not received much attention in official announcements about the grain reforms. Instead, higher grain prices are being blamed on this summer’s floods.

The second change relates to the problem of surplus production. In order to encourage an improvement in the quality of China’s grain supplies, and curb production of low quality grain for which there is no market, the grain bureaus have been given more flexibility to adjust procurement prices to reflect differences in quality. Because quantity not quality has been the main objective of Chinese farm policy, grain quality has traditionally not been an important consideration for grain bureaus. In setting procurement prices, the grain bureaus therefore did not differentiate very much among different varieties of grain. Farmers who produced high protein wheat received no more for their grain than those who produced low protein wheat, and farmers sold tasteless early crop rice at much the same price as better tasting late crop rice. As a result farmers tend to plant better quality varieties of grain for their own consumption, and then plant lower quality, but higher yielding, varieties to sell to the grain bureaus. At the same time, demand for high quality grain has been increasing as urban incomes have risen. As a result, grain bureaus have been saddled with large stocks of low quality grain for which there is no market. The new policy is designed to reduce this burden somewhat.

Twenty Years of Grain Reforms

China has been tinkering with its grain production and marketing system for thousands of years with political authority depending in large part on the ability of the government to assure stable grain supplies. Current policies have their origins in 1978, when the communal system was abandoned and farmers were given somewhat greater discretion under the "household responsibility system" for their activities. The next ten years witnessed a significant boom not only in grain production but in the production of vegetables, fruits and other food and industrial crops as well. By the early 1990's the system of rationing was abandoned as production exceeded consumption and experiments to allow both domestic and international marketing of grains by other than state entities were permitted. In 1994, after a poor harvest, large exports of corn and rising grain prices, the government began to retreat from grain market reforms. The warnings from outsiders that China might not be able to feed itself in the future added to the Government's angst. In 1995, the Governor Responsibility System was introduced (whereby each province was responsible for balancing its own grain supply and demand) and the central government declared its intention to reassert its control over the majority of commercial grain stocks. At that time, the focus was on ensuring stable supplies and prices.

In 1996, at a time of high international grain prices, quota prices for grains were increased sharply as the Government tried to stimulate grain production to assure adequate food supplies. As a result of good weather, higher yielding seeds and higher prices, record grain production occurred in 1996, followed by large crops in 1997 and 1998. In 1997 when large supplies began to depress prices, the protected price was introduced. The protected price was aimed at ensuring farmers that (1) they would receive a minimally acceptable price covering their costs of production, whatever those might be, and (2) that the government would buy any and all grain they wished to sell. In 1997, the government's emphasis was still on maintaining farmers' enthusiasm to produce

grain, thereby assuring its own citizens and the world that China could feed itself, with little discussion of how the higher priced grain would be paid for or by whom. By 1998, with the grain bureau now taking on debt at the rate of nearly \$2 billion a month, the system was read for another round of reforms.

Financial Burden of the Grain System Will Continue

Recent press reports estimate the Chinese government's has lost at least US\$25 billion through its grain bureaus since April 1992, including nearly US\$10 billion in losses from misuse of government funds intended to buy grains from farmers, plus another US\$14.5 billion lost due to selling grain below costs and over staffing. While the reforms may help to cut losses stemming from poor management of local grains bureaus, they do not address the fundamental reason for the losses. Since there is no market mechanism at work in the Chinese grain market, farmers will continue to produce more grain than can be consumed domestically or exported at world market prices without subsidies. Thus, the grain bureaus will be expected to buy more grain, requiring a larger financial outlay, than in the past.

Furthermore, under the reforms, the government will have to buy more not less grain from farmers, thus increasing its costs further. The conventional wisdom in the past few years has been that the Chinese government should control 70 percent of the grains that are commercially sold, which is believed to be around half of what is produced (the rest is consumed on the farm by humans or animals, or sold in small amounts in local markets). With major cereal grain production (rice, corn and wheat) currently running around about 430 million MT, that would mean the government should purchase around 150 million MT of these grains each year (which is less than actual government purchases). But if the government is now expected to buy all of this commercial grain, the amount it needs to buy is much greater--more than 200 million MT.

Under the reforms, grain bureaus are expected to sell grain to users at a price which recovers the cost of the grain; plus the cost of processing, storing and transporting the grain, interest owed on the funds used to buy the grain, and some small profit. In order to encourage the grain bureaus to hold grains when prices are low, the central government has declared that it will pay some storage costs and that the repayment of government loans to buy grains, including interest, will not be due until grain is sold. Further, the Government has also announced a program to increase China's grain storage capacity by 25 million tons. Under these circumstances, grain bureaus can hardly be expected not to hold their old grain in the hope that prices go higher, and in the knowledge that the Government will pay storage charges in the meantime.

Another problem facing the grain bureaus is that most of their capital is tied up in grain stocks, leaving them little cash to purchase the new crop. Further, the new rules (buy high; sell higher) discourage them from selling old crop to buy new crop. In order to alleviate a potential liquidity problem, the central government will provide loans through the Agricultural Development Bank for grain purchases. [Note: unconfirmed reports are that the government is prepared to spend an additional RMB90 billion (US\$11 billion) for this year's harvest.]. These new loans, coupled with deferred interest and principal payments, provide further justification for the grain bureaus to adopt a "wait and see" approach to the reforms.

Even if the grain bureaus are able to cut their losses from current year operations, there is little possibility that they will ever be able to make profits large enough to repay old debt. The management of grain stocks is complicated by arcane accounting systems which calculate the cost of grain by adding interest and other carrying costs to procurement costs. This system means that grain bureaus want to receive a premium for old crop grain which may well be lower in quality than new crop grain. Since they can not sell old crop grain without losing

money, grain bureaus tend to sit on it. As a result there have been reports that some old crop grain, particularly rice and wheat, may no longer be edible. If these reports are true, local grain bureaus would face significant losses in liquidating these stocks.

Grain Distribution System Could Change for the Worse

Private traders have come to play a key role in grain distribution in many areas of China, and it will be difficult to move grain without them. In some areas there is no way for farmers to get their grain delivered to the grain bureaus without going through private traders. In other areas the government grain silos are full, and the grain bureaus will find it difficult to buy and store all of the grain that farmers want to sell. Since private traders have lower overhead costs they can market grain at competitive prices. Therefore, by trying to close private traders out of the grain market, this year's reforms could make China's grain distribution worse rather than better by eliminating the most efficient traders and users and protecting inefficient organizations. The reforms may also make investment in China's grain processing sector less attractive to foreign investors.

There are also concerns that the grain bureaus may abuse their monopoly power in reselling grain. Under the reforms, the grain bureaus are supposed to set their resale prices to cover their costs and a reasonable profit. The reforms do not spell out what a reasonable profit should be, nor do they require any sort of transparency in calculating it. It appears that each provincial grain bureau, indeed each local grain procurement station, is being given flexibility to set their own prices.

It is thus possible for bureaus and stations to charge different prices to different customers.

Variation in prices between provinces is also starting to cause problems. To avoid price competition, grain bureaus in several northeastern provinces reportedly met several months ago to fix prices. Millers in urban areas who must buy wheat through urban grain bureaus report they are having difficulty competing with small rural millers who have lower operating costs and access to cheaper wheat. There are already reports that some grain bureaus are charging lower service fees for feed and flour mills which they own, than they do for private or joint-venture mills. If this practice becomes widespread, it could offer a serious market advantage to government-owned mills over private mills and discourage foreign investment. Another way in which preference can be given to state-owned mills, or to other mills with close government ties, would be to look the other way while state owned mills buy grain directly from private traders or farmers while strictly enforcing the ban on private or joint-venture mills. (In China the amount of feed produced by private or joint-venture mills is disproportionately greater than their number.)

Accommodations are already being made at the local level to allow private traders to continue moving grain, and the number of private traders could actually increase despite the ban on such commercial activity, as laid-off workers from grain bureaus try to start their own businesses. Despite the ban on private trading, in some areas, feed mills report that they will continue to buy from private traders, even, it appears, with the approval of local grain stations to do so. One way in which this will work is for a mill to first negotiate a purchase from the grain bureau, which then commissions a private trader to buy the grain from farmers and deliver it to the user. In another instance, the mill negotiates directly with the private trader who has a Grain Bureau certificate to buy, sell and transport grains. One large private feed conglomerate, with ties to the government, reported that it has received permission to continue purchasing half its corn from private traders and farmers in this manner. This apparent lack of consistency in enforcing the ban on private traders makes it difficult to forecast the impact of the grain reforms.

Little Impact on Rural Income

From the standpoint of farmers, there are concerns that the grains bureaus may abuse their monopoly position in procuring grains. While government grain bureaus are theoretically supposed to buy all of the grain that farmers want to sell, in reality they do not. Farmers report instances in the past where grain bureaus have refused to buy their grain because the grain station did not have storage space or were dissatisfied with the quality. In the past, such farmers had the option of selling their grain to private traders. If the reforms are strictly enforced, farmers will have only one option in selling their grain - the grain bureau.

In reality an underground market will probably develop where farmers will be able to market their grain privately. There are already reports that grain bureaus in some regions are sending out employees to buy grain from farmers at reduced prices. In the end the reforms may result in more mismanagement and profiteering at the expense of farmers, rather than less. When farmers are asked if they are aware of the new policies and their implications for future grain sales, they generally say, "No." When the "reforms" are explained, they respond with skepticism that the reforms will have any positive effect on their lives.

Trade: More of the Same

The 1998 grain reforms represent a step back from a market-oriented grain distribution system. They bring Chinese farm policies no closer to where they need to be for China to join the WTO. Although local grain bureaus will be given some flexibility to adjust prices, the central Government will continue to heavily influence pricing. Grain prices will remain high by international standards, and because these will reflect Government guidance, rather than changes in supply and demand, surplus production can be expected to continue.

As stocks grow to unmanageable levels, more subsidized exports are likely. With high stocks, the Government can be expected to continue restricting imports. China's continued reliance on State planning, rather than true demand-driven signals, will do little to reduce recent volatility in world grain markets. Speculations about China's movement in and out of world markets to fill gaps (real or imagined) in its domestic supplies will continue.

With high grain prices, Chinese industries which depend on grain will become increasingly uncompetitive internationally. The current domestic procurement price for corn (what farmers are supposed to receive) in China is between US\$120-130/MT. By the time the costs of handling and shipping are added (plus whatever profit the grain bureaus deem "reasonable"), the price that industrial users are paying is about US\$170/MT. By comparison, current prices for U.S. corn are less than US\$100/MT, fob Gulf. Getting it to the feed mill in southern China adds an additional US\$50-60/MT, for a total cost of US\$150-160/MT for U.S. corn. By paying the higher price for domestic corn, China's poultry industry is less competitive than other sources such as those in Thailand, who have access to corn at world market prices.

Conclusion

The 1998 reforms reveal, most of all, that China will continue to rely on state planning rather than free markets in the grain sector. While improvements can be made in their financial management, many of the problems that plague the grain bureau system, and thus hurt the interests of the industrial users and other consumers it serves, are likely to continue. The most efficient grain traders and users are more likely to be hurt than state-owned enterprises, especially those that are part of the grain bureau system. Foreign investment in grain transportation

and processing could be further discouraged. China's own exports of grains and associated industries such as poultry will remain or become uncompetitive in global markets without further costly government subsidies. Farmers are unlikely to benefit from these reforms nor is social stability likely to be strengthened. China will remain a big question mark in the global grain system.

While some Chinese policy makers continue to focus on the strategic importance of grain production, others recognize that rural development rather than planned production is the key to China's future. China's progress toward a more market-oriented economy is making prosperity increasingly dependent on finding markets, rather than increasing production. Since the 1998 grain reforms are not likely to solve either China's grain distribution problem, the financial headaches it creates, or improve farmers incomes, a further round of "reforms" is likely. Recent articles in the Chinese press on continuing government losses from the grain distribution system, talks with Government officials and the high prominence given to rural reforms at the most recent Party plenum session all point to further changes in China's grain policy.